CONJONCTURE IN FRANCE

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Hazy skies in Europe

After strong growth in 2017, a slowdown in French economic activity appeared relatively suddenly at the beginning of 2018. Gross domestic product (GDP) increased by just 0.2% in Q1, interrupting the steady growth observed since the end of 2016 (+0.6% to +0.8% per quarter).

This slowdown is not specific to France and can no doubt be explained by a combination of "one-off" factors and more global determinants. 2017 finished on a high note in manufacturing output and the backlash was therefore significant at the beginning of 2018, in particular in transport equipment. On the demand side, household consumption remained sluggish in Q1, pending the rebound in purchasing power expected in the following quarters. Household investment in housing also levelled out after two years of catching up strongly.

However, these factors are not enough in themselves to explain the slowdown in business climates throughout the Eurozone since the start of the year. More global factors are no doubt at play, combining to shape a more overcast, uncertain short-term outlook than in 2017.

The sharp rise in oil prices driven by geopolitical tensions in the Middle East, among other things, is no doubt one of these factors. The sharp rise in the Euro in the course of 2017 may also have weighed down on the competitiveness of exporting companies. Protectionist tensions would appear to be intensifying in the United States, where the gradual tightening of monetary policy and fears of a sharper-than-expected rise in inflation are also accentuating uncertainties on financial markets. Finally, economic activity in certain countries, notably Germany, could come up against production capacity constraints.

Despite these clouds, the international economic environment remains strong. Economic activity should remain robust in most of the emerging countries, while US growth should be buoyed considerably, if procyclically, by a highly expansionist fiscal policy. World trade should therefore keep up its impetus, despite a slight deceleration. The financial markets, meanwhile, seem to be resisting these rising uncertainties.

Eurozone growth in 2018 should therefore be slightly below its fast pace of 2017 (+2.1% after +2.6%) and France is unlikely to repeat last year's growth rate in the short term: activity is likely to progress by +1.7% on an annual average basis, after +2.3% in 2017. It should accelerate slightly in the spring (+0.3% after +0.2%) then again in the summer and autumn (+0.4% per quarter). On the macroeconomic level, the transport strikes are likely to have only a weak impact of no more than -0.1 points of GDP growth in Q2.

Household consumption could pick up a little impetus over the year, driven notably by the acceleration (despite the rise in inflation) in purchasing power expected in the last quarter under the effect of lower social contributions, the reduction in housing tax and dynamic earned income. Corporate investment should hold up despite the slowdown at the start of the year, but household investment is likely to continue decelerating. Foreign trade, meanwhile, should buoy up economic growth, especially at the end of the year, as in 2017, given the expected schedule of aeronautics deliveries.

In this context, job creations are set to remain dynamic, in particular in the tertiary sector, but are likely to slow down in the wake of economic activity. Total employment should therefore progress by 183,000 people in 2018. The unemployment rate should continue to fall, although at a lesser pace than in 2017: it should stand at 8.8% at the end of 2018, representing a fall of 0.2 points year on year.

This scenario remains subject to the many uncertainties in the current international environment, whether economic and financial (oil prices, foreign exchange markets, protectionism, supply-side tensions) or political, such as the consequences of the Italian elections on the effective functioning of the Eurozone. In France, the dynamic purchasing power expected at the end of the year could also drive stronger-than-expected household consumption.

General outlook

A slowdown in international trade at the start of 2018

World trade slowed down in Q1 2018 after a strong year

The imports of the world's main economies, both advanced and emerging, lost a large part of their 2017 impetus at the beginning of 2018. Dynamic trade in the advanced economies in the autumn (+1.8%) gave way to much greater moderation over the winter (+0.4% in Q1). Business climate trends in each major zone also indicate a peak in world activity at the end of 2017, followed by a downturn that was more pronounced in the Eurozone and emerging economies than in the advanced economies outside the Eurozone (*Graph 1*).

In early 2018, activity slowed down in the advanced economies...

In most of the advanced economies, brighter activity in 2017 gave way to a slowdown in Q1 2018. While gross domestic product (GDP) grew less in early 2018 than at the end of 2017 in the United States and Eurozone (+0.5% after +0.7% in the US, +0.4% after five consecutive quarters of +0.7% growth in the Eurozone), it stalled in Japan (–0.2% after +0.3%), after a growth rate not seen since 2013 (+1.7% in 2017). In the United States, the slowdown in GDP concerned all the main items of demand, while in Japan it was the continuing decline in household investment (–1.8% after –2.7% in Q4 2017) combined with the stagnation of other demand components that explains the slowdown that was observed. In Europe, it would appear to be exports and investment that decelerated.

...and notably in the main European economies

The pace of growth slowed in the main European economies at the start of the year, whether in Germany (+0.3% after +0.6%), France (+0.2% after +0.7%) or the United Kingdom (+0.1% after +0.4%). Spain and Italy kept up their rate of growth, meanwhile, at a sustained pace for the former (+0.7% to +0.9% per quarter over the past three years) and a more modest pace for the latter (+0.3% to +0.4% per quarter since spring 2017).

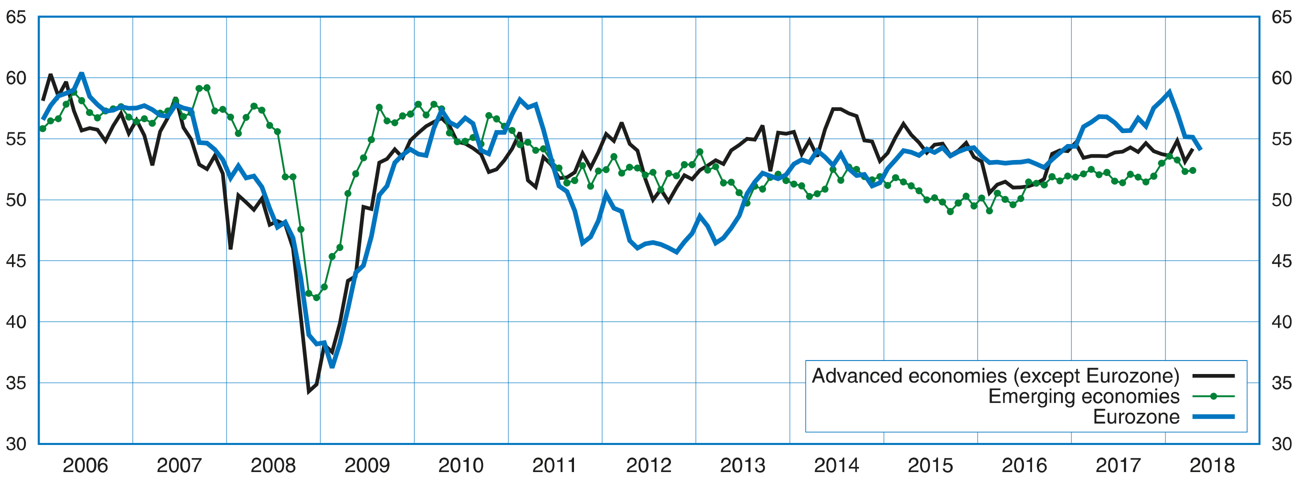
Growth remains sustained in the main emerging economies

In the emerging economies, activity picked up in Russia and Brazil in 2017 after two years of recession and growth in India and in the countries of Central and Eastern Europe is still dynamic. Finally, the very gradual slowdown in the Chinese economy is continuing, although the growth posted there still remains substantial (+1.6% in Q1 2018).

After a vigorous end to 2017, activity in France loses its impetus

In 2017, growth in French gross domestic product (+2.3%) was at its strongest since 2007 (Focus: *the quarterly accounts have switched to the 2014 base*). It was buoyed up mainly by dynamic investment by corporations (+4.4%) and households (+5.6%). Corporate investment stalled at the start of the year (+0.1% in Q1 2018 after +1.2%). This slowdown was driven mainly by the

1 - Although it remains on a positive trend, the business climate has fallen back more in the Eurozone than in the other economies



Source: PMI Markit

downturn in investment in manufactured goods, while investment in services is still progressing strongly. Household consumption grew moderately in 2017 (+1.1%) and remained at the same sluggish pace in Q1 2018 as at the end of 2017 (+0.1%). Foreign trade fell back slightly at the start of the year after strong exports at the end of 2017 (+2.3%). The latter led notably to a considerable contribution of foreign trade to growth in Q4 2017 (+0.7 points). This contribution fell to zero in Q1 2018.

Normalisation of monetary policy ahead of phase in the US.

The Fed continues to raise the American base rate

The Fed has continued its programme of progressive base rate hikes in a context of rising inflation (to +2.3% year on year in Q1). Inflation is likely to rise to +3.0% in Q2 2018 due to the rise in oil prices and a highly favourable labour market situation (unemployment at 4.1% at the start of 2018). The US base rate has been at 1.75% since March 2018 and could be raised two or three more times between now and the end of the year. In parallel, the Fed is likely to step up its balance sheet reductions, unlike the European Central Bank (ECB) which is pursuing its quantitative easing on a smaller scale.

US rates rise much more than European rates

In the Eurozone, the ECB is continuing its asset purchases, at least through to September 2018. It is likely to cut the pace by half, however, in 2018 (€30 billion a month) from 2017 levels. As the ECB maintains its very low base rates (refinancing rate of 0.0% since March 2016), sovereign rates in the Eurozone are likely to remain much lower than in the US (about 0.5% in Germany and 0.8% in France, against close to 3.0% in the US for the 10-year rates). Recent political uncertainties in Italy and Spain have led to a sudden rise in the rates on national 10-year borrowing (*Graph 2*).

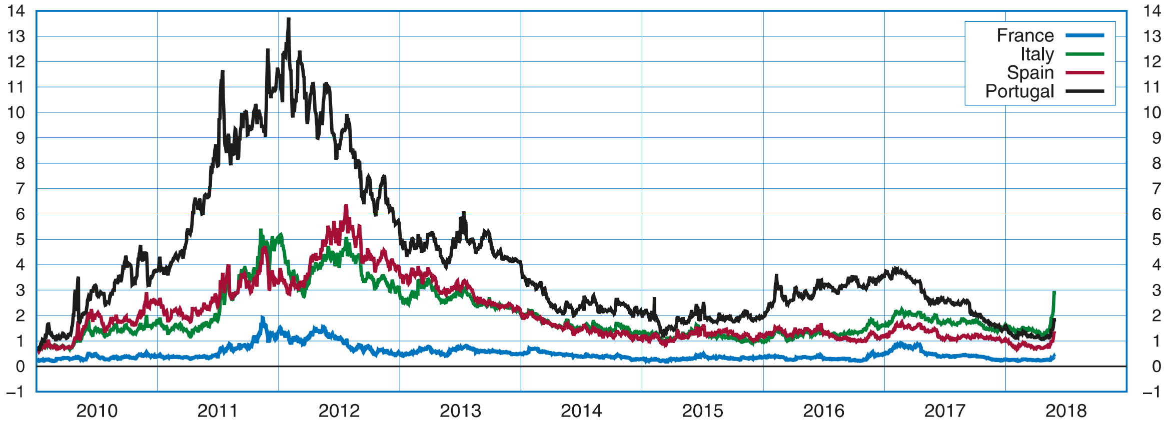
The Euro falls back slightly after rising sharply in 2017

After reaching $1.25 at the start of the year, the Euro returned to just under $1.20 in the spring, allowing the real effective exchange rate of France to fall back after rising significantly in 2017.

The deficit on the physical market in petroleum products pushes the price per barrel upwards

In 2017, the agreement to limit the oil output of the OPEC countries was complied with and supply therefore remained slightly below demand. This situation could continue through 2018. Current petroleum product stocks are still relatively high and should continue to decrease in the course of the year. Demand is likely to continue progressing at a steadier rate than supply, mainly due to China, the emerging nations and the US. Consequently, in a context of geopolitical tensions in the Middle East, the price per barrel of Brent exceeded $75 in spring 2018, from around $50 in mid-2017.

2 - Sovereign rates show the differences in monetary policies and political uncertainties in southern Europe



Source: DataInsight

Fiscal support in the US

Tax incentives should drive investment and combine with budget expenditure to support US growth

Despite a less positive business climate in H1 2018 than at the end of last year, the US economy should accelerate in the spring (+0.7%). Tax cuts are likely to buoy up corporate investment (+1.6% in Q2 after +2.2%, then +2.0% per quarter in H2) among other things, notably via additional depreciation measures. Household income should benefit from the tax cuts passed at the end of 2017 and dynamic wages. Household purchasing power should therefore be much more dynamic in 2018 (+2.2%) than in 2017 (+1.2%), despite the upturn in inflation through to the end of the year. Household consumption should continue to grow by 0.7% in Q2 and then 0.5% per quarter, while the savings ratio is likely to remain barely above 2.9%. All in all, the US economy is set to accelerate in H2 (+0.8% per quarter), resulting in higher annual growth than in 2017 (+2.8% against +2.3%). The procyclical nature of US fiscal policy could bring a risk of economic activity overheating, however.

In the UK, activity should rebound in the spring after a winter hit by snowfall (+0.5% in Q2 after +0.1%), then progress at a slower rate (+0.3% per quarter), hit by wait-and-see attitudes towards Brexit.

Growth remains robust in the main emerging countries

In China, growth is set to keep up a steady pace in 2018, barely down on that in 2017 (+6.4% after +6.9% in 2017). From Q2 2018 onwards, Chinese exports should progress moderately (about +0.9% per quarter), slowed down by the past rise in the Yuan and less dynamic foreign demand than in 2017, while imports are likely to stall after a dynamic Q1, before growing by 1.5% per quarter in H2 2018. The Russian and Brazilian economies are accelerating and should benefit from low base rates and weak inflation in 2018. Activity in India and Eastern Europe should also remain dynamic. Turkey, however, is likely to be hit by the rise in inflation further to the slide in its currency.

International trade to be less dynamic from spring 2018

World trade should grow by around +1.1% per quarter from Q2 2018 onwards. The rate at the end of the year should be more moderate than in 2017, for both emerging and advanced economies, as suggested by the less favourable trend in business climates. The risk of more protectionist trade policies is also likely to weigh down on international trade dynamics in H2.

Eurozone growth in 2018 to be slightly below its 2017 rate

As suggested by the business tendency surveys, activity to slow down from its 2017 pace

The European business tendency surveys show a downturn in the opinion of business leaders since the start of the year in the four main Eurozone countries and in all sectors (industry, services and commerce), except for construction. Following on from Q1 2018, growth in Eurozone GDP should therefore be moderate in Q2 (+0.4%). After reaching a rate not seen since 2010 in 2017 (+0.7% per quarter), the Eurozone is likely to return to a more moderate pace in 2018. Quarterly growth in GDP from Q2 onwards should be +0.5% in Germany (+0.4% at the end of the year, slowing down slightly due to supply-side constraints), +0.3% in Italy and +0.6% in Spain. All in all, after growth of 2.6% in 2017, Eurozone GDP should progress by 2.1% in 2018.

European wages to drive purchasing power

Eurozone employment is likely to increase by 1.5% in 2018 (after +1.3%) and real wages to accelerate (+0.9% after +0.2%), with the result that gains in purchasing power are set to exceed those in 2017 (+2.1% after +1.4%). After progressing by 0.5% in Q1, household consumption is set to slow down in Q2 (+0.4%) and then accelerate to +0.5% per quarter in H2.

Eurozone investment to slow down

Investment in construction should continue progressing robustly in the Eurozone in 2018 (+3.6% after +4.1%). In capital goods, the favourable economic situation and production capacity tensions should lead companies to maintain a high rate of investments. The passing fall in Q1 (–0.5%) should be made up for by the dynamism of the following quarters (+0.9% to +1.2% per quarter), bringing annual growth in investments in equipment to +4.5% in 2018, slightly down on that in 2017 (+5.4%)

French foreign trade to accelerate over the year

After a break at the start of the year, exports should be more dynamic, driven by world demand for French products

French exports fell in Q1 2018 after an excellent Q4 2017 (–0.3% after +2.3%), in particular in transport equipment. The rhythm of aeronautics deliveries is set to accelerate over the year, notably in autumn 2018, with a comparable progression in manufacturing exports to that in Q4 2017. Exports in agriculture and services should also accelerate in 2018. World demand for French products is likely to grow by 4.3% on average in 2018, buoying up exports which should progress by 4.4% on average over the year (after 4.7% in 2017).

The contribution to growth of foreign trade to be weak through to the end of the year

Imports also fell back at the start of 2018, but should return to a progression of more than 1.0% per quarter from Q2 onwards. All in all, foreign trade is set to contribute positively to growth at the end of 2018. On an annual average basis, it should contribute +0.5 points to growth in GDP, driven more by the big deliveries at the end of 2017 than by the contributions of Q4 2018.

French activity to slow down from its 2017 pace

The business climate has fallen back after reaching the summits at the end of 2017, but supply-side tensions remain

In all sectors except building, the surveys have fallen back from their highs at the end of 2017 or in January 2018 (*Graph 3*). The business climate in France thus slipped continuously from 112 in December 2017 to 106 in May 2018. However, supply-side tensions continue to progress or remain at high levels. For instance, the production capacity utilisation rate in industry is still above 85%, its highest since summer 2008. In construction, it is even above the 89% mark.

Production rates slightly down on the end of 2017

Manufacturing output was particularly strong at the end of 2017 but contracted in Q1 (–1.0% after +1.3%). It is likely to progress less quickly than in 2017 over the following three quarters. Over the year as a whole, manufacturing output should increase half as quickly as in 2017 (+1.2% on an annual average basis in 2018). Production of market-sector services excluding commerce is likely to continue its sustained progression of +0.4% to +0.5% per quarter through to the end of 2018, a pace that is still less dynamic than last year, however. Dependent as it is on the outlook in industry and services, commerce should also see a less rapid expansion in 2018 than in 2017. Construction is likely to progress a little less quickly than in 2017 from the spring onwards (from +0.3% to +0.4% per quarter), notably due to the slowdown in household investment in building. Finally, activity in transport is likely to be affected in Q2 by the rail-sector and air transport strikes, before returning to normal in the summer.

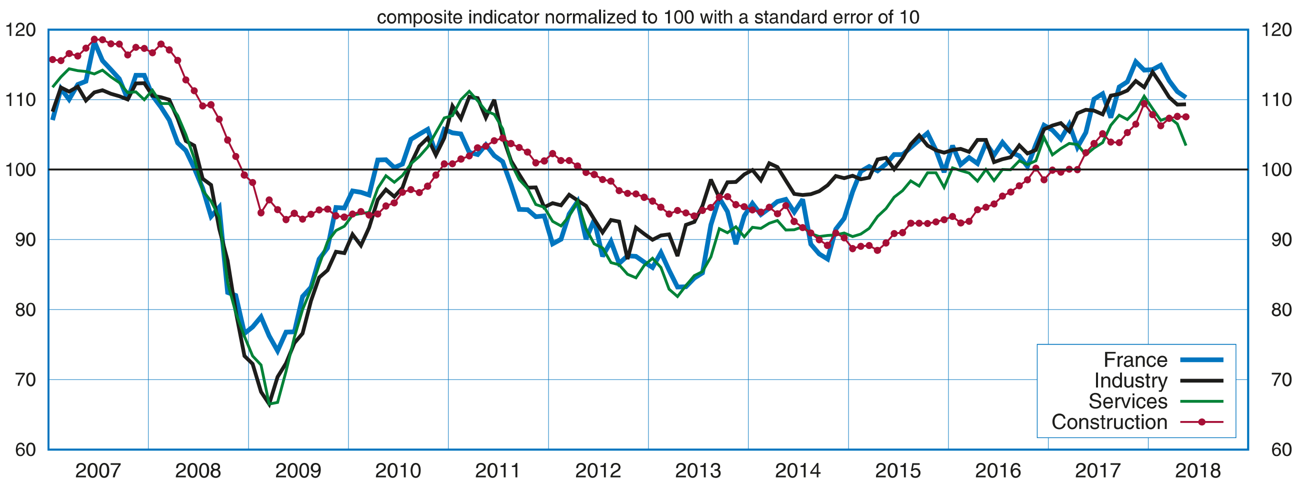
All in all, GDP is set to progress less quickly than in 2017, by 0.3% in Q2 and then by +0.4% in Q3 and Q4 2018 (*Graph 4*). Annual growth in the French economy is expected to stand at +1.7% in 2018 after +2.3% in 2017.

Following in the wake of activity, job creations set to continue at a more moderate pace

Market-sector employment to slow down in 2018

Steady growth in 2017 was beneficial for market-sector payroll employment which increased strongly by 172,000 jobs in H1 then by 161,000 in H2. At the beginning of 2018, the business tendency surveys report a less favourable situation for changes in the workforce, while there are still considerable difficulties in recruitment. In H1, market-sector payroll employment should grow at a lesser rate than in the previous year (+83,000), remaining at that pace in the second half of the year (+80,000). Job creations in market-sector services excluding temporary employment are likely to ease (+134,000 over the year, after +175,000 in 2017), making up the main part of the rise. Temporary employment

3 - The business climate in France has been falling since the beginning of 2018



Source: Insee

should slow down significantly (+17,000 after +124,000 in 2017) while industry is likely to lose jobs again.

Non-market sector employment is likely to suffer from the drop in subsidised employment over the first half of the year and then rebound in H2

Non-market sector employment declined in H2 2017 (–9,000), driven by the fall in the number of beneficiaries of subsidised jobs, notably with a sharp reduction in the number of people starting on the former contracts from mid-2017 onwards. This trend should fade out in H1 2018 (–3,000) then be reversed in H2 (22,000), driven by the phase-in of the new "Employment Skills Pathway" system. All in all, employment (including non-payroll employment) should progress by 81,000 in H1 then by 102,000 in H2, making a total of 183,000 in 2018 as a whole.

The unemployment rate to fall again in 2018, although at a less rapid pace than in 2017

Quarter-to-quarter fluctuations aside, the unemployment rate should continue to fall in 2018 to 8.8% at the end of the year, after 9.0% at the end of 2017 and 10.0% at the end of 2016. With job creations remaining solid, the downwards trend in the unemployment rate should continue, although at a lesser pace than in 2017.

Tax measures should support gains in purchasing power through to the end of the year

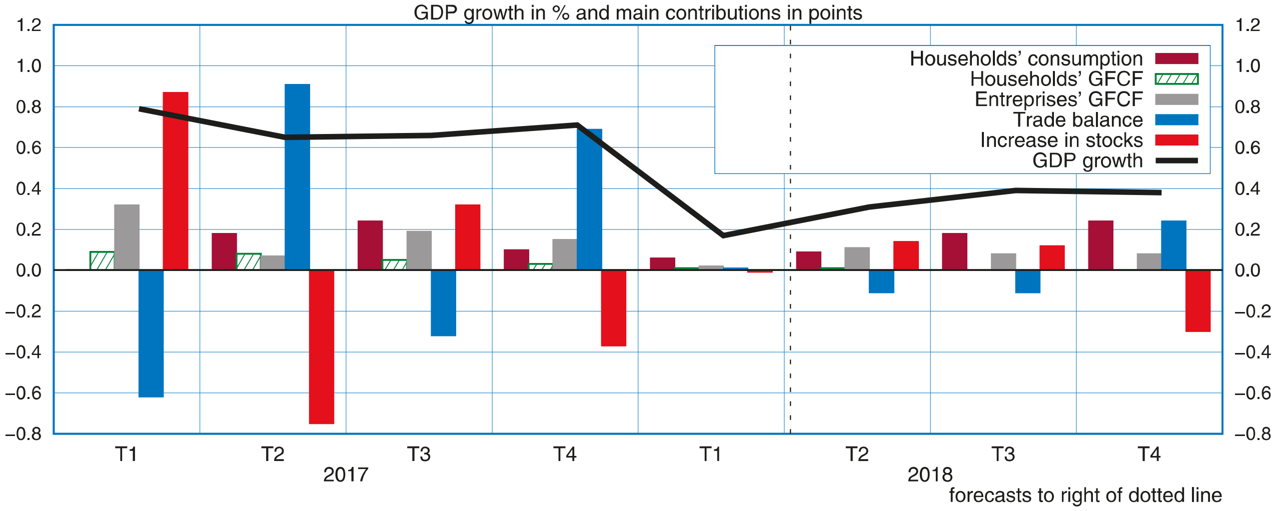
Inflation picked up in the spring while core inflation is likely to increase a little

While inflation was relatively moderate in 2017 (+1.0% on average), it picked up significantly over the winter and then spring 2018, reaching +2.0% in May. This acceleration in consumer prices has been driven in particular by rising energy prices and the tobacco price hike. Although core inflation has also risen (from +0.5% on average in 2017 to +0.8% in April 2018), it has increased a little more moderately than headline inflation. Dynamic wages and the fall in unemployment are likely to contribute to pushing that figure up to +1.1% by the end of the year. Headline inflation is likely to reach 2.3% over the summer and then slip back to +1.7% at the end of the year.

Real wages set to be held back by the rise in inflation

Nominal wages per capita in the non-agricultural market sector should accelerate a little in 2018 (+2.1% after +1.7%), in light of the recruitment difficulties reported by employers. However, the acceleration in consumer prices is likely to shave a little more off real wages than in 2017, with the latter progressing by 0.5% in 2018, as in 2017. In the civil service, the freezing of the index point and postponement of certain modalities of the Professional Career Paths, Careers and Remunerations (PPCR) protocol are likely to contribute to a slight slowdown in nominal wages

4 - Economic activity should grow in 2018 at a lesser rate than in 2017



Sources: Insee

Dynamic earned income to buoy up purchasing power in 2018, although offset by the upturn in inflation

Earned income should progress by close to 3%, thanks to job creations combined with wages that continue to be dynamic, buoying up the gross disposable income of households (+2.6% in 2018 after +2.7% in 2017). However, the upturn in inflation in 2018 is likely to slow down the progression in purchasing power on an annual average basis (+1.0% after +1.4%, Graph 5). The sub-annual profile should also be marked in 2018 by the tax calendar: after falling back at the beginning of the year, purchasing power is set to rebound sharply at the end of the year, notably due to the elimination of the remaining unemployment insurance contributions for salaried employees and the reduction in housing tax for certain households.

Household consumption to progress once again at a moderate rate

Households likely to consume at a moderate rate, affected little by the fluctuations in their purchasing power

Despite relatively strong gains in their purchasing power in 2017, household consumption increased moderately (+1.1%) in light of the positive economic situation. This moderation is likely to continue in 2018, with consumption progressing by just 1.0% on average over the year. Households are likely to smooth out the effects of quarterly variations in purchasing power on their consumption. They are therefore likely to accelerate the pace of their purchases only in a limited manner through to the end of the year. Their savings ratio should therefore reach 15.1% at the end of the year, after a low of 13.6% in Q1 2018.

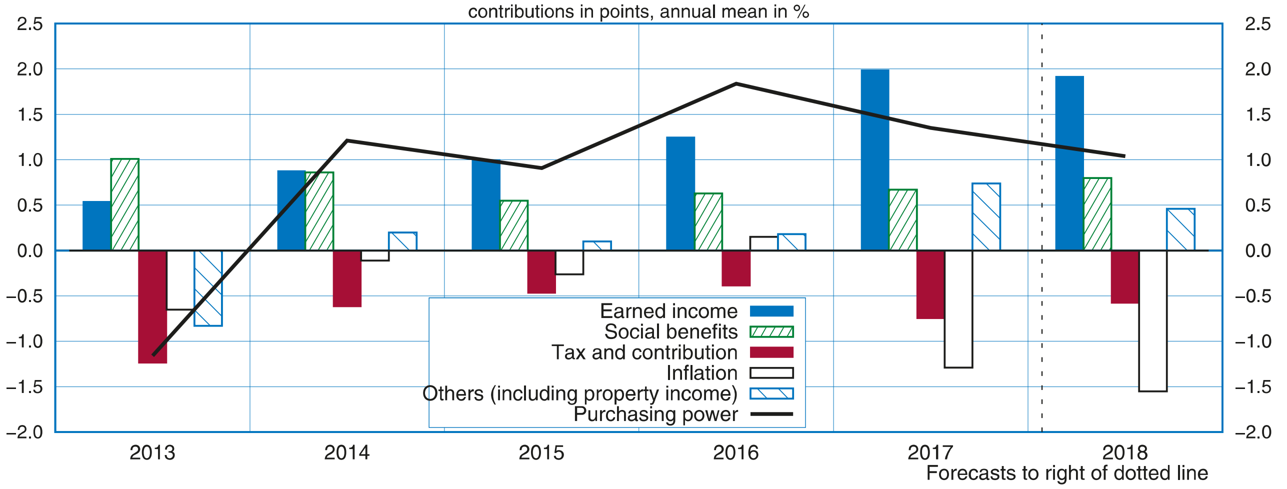
The fall in consumption of manufactured goods in Q1 (–0.2%) is likely to be followed only by a modest acceleration over the following quarters, resulting in a net slowdown in household purchases of manufactured goods in 2018 (+0.9% after +1.8%). Consumption of market-sector services is likely to keep up the same pace as in 2017 (+1.8%). Finally, consumption related to foreign tourists should be nefit from the catch-up in tourist visitor numbers after the sharp fall in 2016.

Corporate investment sustained once again, notably in services, while household consumption decelerates.

The corporate investment rate continues to break records

After progressing strongly in 2017, investment by non-financial enterprises (NFE) should remain dynamic in 2018 (+3.1% after +4.4%), despite the passing slowdown in Q1 (+0.1%) driven mainly by the fall in corporate investment in manufactured goods. In Q2, it should progress by 0.9% and then by +0.6% per quarter in H2. At the end of 2018, that should take the investment rate of NFEs to 22.4%, one point above its previous high posted in 2008. Production capacity tensions and the one-point rise in the rate of the tax credit for encouraging

5 - Robust earned income should continue to bring steady gains in purchasing power, despite the upturn in inflation



Source: Insee

competitiveness and jobs (CICE) paid out in 2018 for 2017, explain the continuing rise despite the slight slowdown in activity. This dynamism should be driven mainly by investment in services, which should gain almost 6% in 2018, as in 2017, while investment in construction and in manufactured products is likely to increase by a little over 1% on average over the year

Household investment to slow down, while general government investment progresses again significantly

Household investment posted its highest growth since 1999 in 2017, but should slow down significantly in 2018 (+1.6% after +5.6%). Sales of existing homes, which contribute via investment in real estate services, are likely to fall back slightly, as are building permits. Over the forecasting period, household investment should therefore be almost stable. After falling for five years, public investment rebounded in 2017. It is set to accelerate in 2018 (+2.4% after +1.6%), profiting notably from expenditure relating to the Greater Paris Express construction sites.

Increasing uncertainties

Monetary and financial risks remain in a top-of-cycle context

While the main central banks are tightening their monetary policies very gradually, the current phase brings with it a risk of financial correction linked to the risk of overheating, the scale of debt and the levels reached by stock markets. The expansive fiscal policy conducted by the United States also increases this risk.

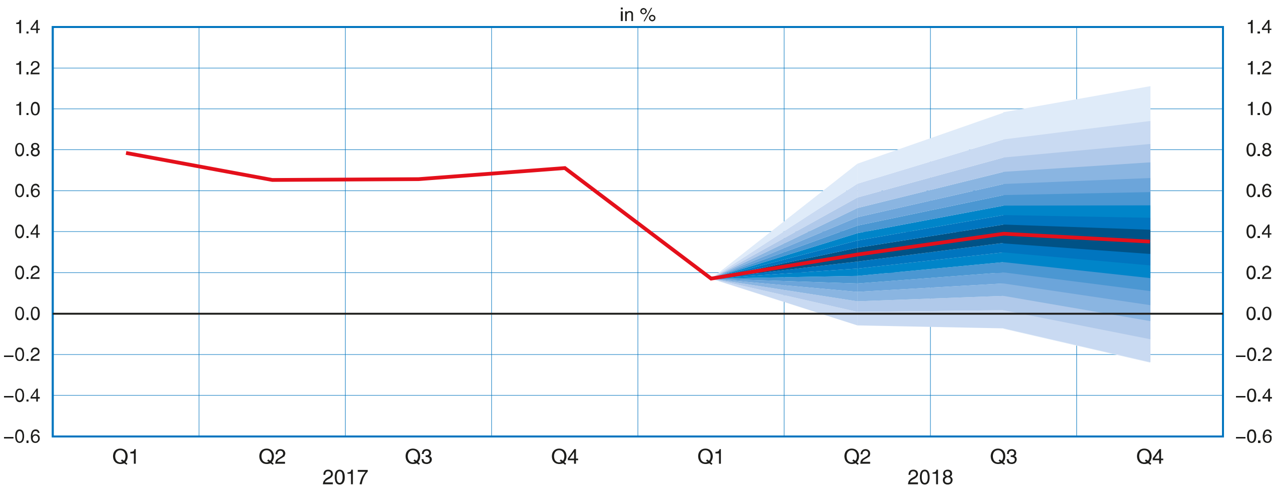
Political uncertainties and geopolitical tensions continue

While political uncertainties continue in Europe (in Italy and Spain, according to the policies conducted by their new governments, and in the UK with Brexit implementation), there are also protectionist risks for the strength of international trade (in particular between the US, China and Europe). Oil markets could also be hit by an upturn in tensions in the Middle East.

Supply-side tensions could end up limiting production in certain countries

Some countries, in particular Germany, have reached unprecedented levels of strain on their production capacities. For the moment, the absence of any marked upturn in inflation (whether in prices or wages) suggests that their economic activity can continue at a steady rate. These strains could end up holding back their growth in time, however. Conversely, household consumption in France and Germany could be more dynamic than forecast, given the large gains in purchasing power that are expected (in particular at the end of the year in France). ■

6 - Fan chart for *Conjoncture in France*



How to read it: the fan chart plots 90% of the likely scenarios around the baseline forecast (red line). The first and darkest band covers the likeliest scenarios around the baseline, which have a combined probability of 10%. The second band, which is a shade lighter, comprises two sub-bands just above and just below the central band. It contains the next most likely scenarios, raising the total probability of the first two bands to 20%. We can repeat the process, moving from the centre outwards and from the darkest band to the lightest, up to a 90% probability (see *INSEE Conjoncture in France* for June 2008, pages 15 to 18). It can therefore be estimated that the first estimate that will be published in the quarterly accounts for Q2 2018 has a 50% chance of being between +0.2% and +0.5% ; for Q3 2018, up to a 90% probability the estimate will be between –0.1% and +1.0% .

Source: INSEESource: